

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION

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Manufacturers Investment Credit

**Ray Rossi
Director, External Tax Affairs
Intel Corporation**

The Committee staff has requested that I address Intel's experience in helping secure passage of the Manufacturers Investment Credit (MIC), our reaction following its enactment, and the need for it in the future. Accordingly, these comments will be divided into three parts; PRE-MIC, POST-MIC, and CURRENT.

PRE-MIC –

Prior to the passage of the MIC, Dr Gordon Moore, a founder and then-Chairman of Intel, accompanied me to Sacramento to urge that a sales tax exemption be passed for equipment (manufacturing and research), and facilities of California manufacturers. This was in light of Intel's ongoing site selection process, in which Gordon and I had both been participants – my role was to provide relevant tax input to be displayed in a ten-year comparative operating cost model then used by Gordon and other senior management to make decisions of how much, when, and where capital investments would be made. Gordon was well aware of, and cited, the adverse difference in comparing California, at that time the site of an Intel fabrication facility, with other jurisdictions, for example, Arizona, that already had the desired sales tax exemption; this was referred to as an "\$80 million difference", based upon the assumed cost of at least \$1B for a wafer fabrication facility (accurate at that time, but now escalated to a cost of \$2.5B or more, given recent new technology and building needs). Arizona was at that time the location of certain Intel operations,

including fabrication, and also the location of those of one of our major competitors at that time, Motorola. Also of note, Oregon, another location of Intel fab facilities had, and continues to not have, no sales tax at all. When asked whether this difference would mean that Intel would never invest in a new or expanded fabrication facility (fab) in California, absent passage of the sales tax exemption, Gordon replied – no, but if he were to do so, he would need a very good explanation to his Board, his employees, his shareholders, his customers, and other interested parties why the company, under his stewardship, would ignore an \$80M cost savings.

The reality of company investment decisions is that taxes do matter, and after several possible location have been identified in which Intel can successfully operate, taxes matter a great deal. With a few relatively simple assumptions, the potential tax cost of various sites can be easily quantified, whereas certain other criteria taken into account, like the quality of the education system, are not as easily quantified nor as visible as a relative difference in the model. Currently, at least seven other such qualified fab operating locations have been identified, because Intel already successfully operates fabs there; Arizona, New Mexico, Oregon, Massachusetts, Colorado, Israel, and Ireland. Of note is the relative larger investment aid provided by foreign locations – for example, in the case of Israel, the government contributed roughly two-thirds of the cost of Intel's first fab built there some years ago. In addition, Intel is often approached by yet other new potential locations, urging us to consider their attractiveness as fab sites. That attractiveness is considerable. One such example, Florida, has an investment credit that provides 5% per year of the original cost for a 20-year period.

In this context, when asked whether Intel would invest in manufacturing and research productive assets in any event, I have answered yes in the past, that we will continue to invest in such assets because our business depends greatly on the state-of-the art facilities and technology. However, that is the wrong question – the right one is

not whether we will invest, but where. It is also important to note that given the rapid pace of technologic change and developments, there is a need for frequent new rounds of capital investment in existing facilities to retain their relevance to the marketplace – such capital additions are ongoing, but also entail even more substantial periodic expenditures to retrofit a fab, lest it otherwise, in a relatively short period of less than five years, become the “dinosaur” of the family of facilities, and be at risk of closure.

Ultimately, the California legislature passed the 6% MIC, rather than the desired sales tax exemption, which would provide a profitable company, such as Intel, a \$60M savings, rather than \$80M, on the \$1B fab, discussed above. The MIC was crafted to apply to equipment (both manufacturing and research) of manufacturers, as well as special purpose buildings (to cover the building facilitation required to outfit and house fab clean rooms), and also capitalized labor (for those taxpayers who self-construct their productive assets rather than purchase them. A sales tax exemption was also passed, but only to apply to start-up companies. Later, another sales tax provision was added which could be claimed in lieu of the MIC.

POST-MIC –

Although Gordon Moore’s response, mentioned above, was appropriate and accurate, after the MIC passed, Intel’s actions indeed spoke louder than Gordon’s words: the MIC enabled a torrent of new capital investment in California. Within a year of the MIC’s passage, a \$700M investment in the fab facility in Santa Clara was announced (once announced, such investments may be made over a multi-year period, given their magnitude and required installation and construction time). Also, a building under construction in Folsom, to house research operations, was doubled in size to be a four-story facility instead of two. Subsequently, in Santa Clara, a further periodic new capital investment in excess of \$500M was made in the ’98-99 time frame. Coupled with ongoing investments in the Santa Clara facility,

these post-MIC investments, added in total about \$1.7B. In addition, a new mask-design facility at another Santa Clara site required another \$230M investment. In Folsom, two more four-story buildings have been added, and all post-MIC investments there total about \$800M. More important than the added invested dollars, they have also enabled the Santa Clara and Folsom sites to retain their vitality and currency of technology, and have made Intel's presence in California second only in headcount to its presence in Oregon - this is among not only U.S sites, but worldwide. Current employment is about 14,500, compared to about 14,600 in Oregon.

The crucial role of the MIC can better be understood when it is also known that, of the Intel fab sites in U.S. and worldwide, California has the highest operating cost per wafer, utilizing the same process and technology and after eliminating any extraordinary start-up and/or phase-down costs; California cost per wafer is two and a half times the lowest cost location, and 33% higher than the next highest cost site. It is important to note the key symbolic and economic role that has also been played by the California R & D Tax Credit, which as a permanent 15% Credit applicable to research labor and materials (but not machinery and equipment) complements the MIC, and ranks among the best research credits in the country.

It is also important to note that although the MIC has allowed Intel to retain and grow manufacturing and research jobs in California, only direct manufacturing jobs would be counted toward the required 100,000 jobs threshold first applicable on 1/12/01, and then each year thereafter. Not counted as well for the 100,000 job count would be the significant number of indirect construction and support jobs which the addition of new capital investment dollars produce. In the typical year-plus construction period (usually about 18 months), it is common for construction personnel to equal around 2/3rds of the direct employee headcount. Also, technical support personnel will be required as an ongoing requirement relating to the operation and maintenance of the facility in which the new equipment is housed. Also not counted as an

addition in manufacturing jobs for purposes of the 100,000 jobs requirement would be those direct jobs retained through the investment of additional dollars - although sustaining the existing headcount, these jobs would not necessarily add headcount.

CURRENT –

The semiconductor industry, as are many others, is in the midst of a prolonged downturn. The post dot-com, post-9/11 economic challenges have combined to create an unprecedented economic multi-year recession. The recent Joint Venture: Silicon Valley Network 2003 Index cites a finding that, relative to the rest of the nation, Silicon Valley is losing its concentration of employment in all reported areas, except biotech. This includes a substantial decline in both semiconductor and semiconductor equipment manufacturing employment concentration.

Of note is the recent Intel announcement of its expected capital spending for 2003 – it is anticipated to be around \$3.7B, a billion less than 2002 spending and about three billion less than spending two years ago. No longer can I answer the “whether” question, discussed above, with the answer given in the past. Unlike the past, where capital spending virtually consistently increased as a matter of course and “where” was the relevant question, this is no longer true; the MIC is now essential also to leverage increasingly hard-to-find capital dollars to greater extent.

The fact that the 100,000 increase in manufacturing jobs is now in jeopardy of being lost is indicative of numerous cost pressures which emerged disproportionately in California, subsequent to the last downturn from which the MIC emanated – for example, substantially increased energy and workers compensation costs. Also, the strength and the sustained period of the current downturn is unprecedented for California manufacturers, especially high-tech.

The MIC has a strong correlation to job creation and retention, and under more predictable circumstances contemplated when the MIC was passed, during the interim period of 1994 through 2000, the decline in manufacturing jobs was reversed and the 100,00 jobs exceeded by at least another 100,000. Notable is the similarity of the percentage of jobs in the high-tech manufacturing sector, cited in a recent Milken Institute study, entitled The Economic Impact of a Sales Tax Reduction on Manufacturing Equipment, almost 40% of the state's manufacturing jobs, and the percentage of slightly over 40% of MIC claims by high tech computer and electronic equipment manufacturers, as reported by the Legislative Analyst's office MIC Study.

Cost differentials of California versus other manufacturing locations continue to grow (especially compared to offshore locations, including China, given its emergence as a WTO member country). Importantly, numerous other states currently offer not only investment credits, but also sales tax exemptions on manufacturing and/or research equipment. Over two-thirds of the states provide sales tax exemptions for manufacturing assets, and over one-quarter have such exemptions for research assets. Over three-quarters of the states have investment tax credits of varying types, and almost half have both credits and sales tax exemptions applicable to manufacturing assets. In contrast, California has only the 6% MIC investment tax credit (currently in jeopardy), equal to about three-quarters of a sales tax exemption. The current California sales tax exemption is confined to start-up companies or those who could claim the MIC but instead chose to claim the sales tax exemption. In any event, California is not competitive with those states, including several major industrial ones, currently offering both an investment credit and a sales tax exemption – here it is one or the other. The MIC, when enacted, was applicable in the first year thereafter, but the MIC claim for that year was delayed until the following year – a similar way of delaying the revenue impact to the state, but gaining the stimulus effect immediately (save for the time value of money) could be utilized to enhance the MIC.

Now is not the time for the MIC to be left to expire - rather it should offer an opportunity for renewal, and if possible, enhancement, including a complementary sales tax exemption. It is important to note that the many (non-start-up) companies currently experiencing losses cannot benefit from the MIC, but could through a sales tax exemption. In addition, research capital investments are ever more critical by not only those also manufacturers, but in general. Intel's management has stated frequently that new technology is critical to help speed and sustain an economic recovery. A complementary sales tax exemption and/or the MIC (if a reenactment opportunity occurs or is necessitated) could stimulate greater research capital investments by extending these provisions to all research asset investments, not just those of manufacturers. As stated above, the research credit applies only to labor and materials, not capital assets, and has no impact with respect to such research capital investments.

It must be noted that the 100,000 jobs threshold was at the time of passage of the MIC the preferred choice between it and a "sunset" in a fixed period of years. That possibility is once again being discussed as a structural reform/improvement for California's tax system. In reality, sunsets are inherently counter-productive to sound business decision-making, which must accord with and be based upon known and reliable, certain information. A sunset would cheat the MIC and all other similar provisions (including the current permanent research credit) of having the maximum impact intended by the legislature. As discussed above, business location/reinvestment/expansion decisions are made on projected operating costs over a period of years. If a sunset interrupts the analysis period, the beneficial cost effect of the tax provision will not be taken into account as a positive factor in the decision-making process – it cannot, as the continuation of the favorable provision is not a reliable fact, it is at best a hopeful assumption.

CONCLUSION –

The MIC has been instrumental in Intel's growth of both its manufacturing and research presence in California, and the jobs that depend upon that continuing, and growing, presence.

Now is the time the MIC is needed more than ever in order to help retain this state's current level of competitiveness for additional manufacturing and research investments. Its demise would be not only untimely, but also unwarranted. The MIC produced a reversal of manufacturing job losses in the early nineties, and restored job growth to the manufacturing sector. It should be allowed to continue in order to do the same again, especially given the serious and unprecedented challenges now facing California's manufacturers. In addition, consideration should be given to possible enhancements of the MIC, including a sales tax exemption to complement it.

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